HOW TO USE ESG RATINGS SMARTLY

White Paper

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ESG (environmental, social and governance) ratings are complex and getting more so. Lively debate has been triggered by discrepancies such as Tesla being removed from the S&P 500 ESG index over concerns about working conditions and automated driver safety, while ExxonMobil stayed put[1]. A lack of consistency between rating agencies has been in the spotlight for a while and was highlighted again at the end of June by the European Securities and Markets Authority (ESMA), which called for regulation of the "immature but growing" ESG ratings market[2]. Why do ESG ratings vary so widely, and what can we do about it?

Key points

- *The correlation between major ESG ratings is, on average, 0.61. This means that the same company can be assigned a wide range of ratings by different providers. In comparison, mainstream credit ratings have an average correlation of 0.96.*
- *The reasons for this divergence between ESG ratings include inconsistent and scarce data, a heterogeneous market of ESG ratings providers, and differences in methodologies.*
- *Despite divergence, investors should not deny the concept of ESG ratings as being "futile", but rather recognise the complexity of the field. Regulation and non-financial reporting standards are developing quickly to increase transparency and standardisation in the industry.*
- *Given the challenges of ESG ratings, there is added value that we as a bank can bring to clients by providing in-house analysis and collaboration with external ratings providers, as well as by helping them navigate the shifting regulatory universe.*

Correlations are low

MIT research has found that the correlation between the ESG ratings of six major agencies – MSCI, Sustainalytics, Moody's ESG, S&P Global, Refinitiv, and KLD – is, on average, 0.61[4] (with 1.00 representing a perfect correlation and -1.00 a perfect negative correlation).

What this means is that the same company can have a wide range of ratings from different providers. In comparison, mainstream credit ratings from Moody's, Standard & Poor's and Fitch are correlated at 0.96. This means that there is a high probability that a bond will be given similar or close ratings by the three agencies.

Low correlation between ESG ratings makes them difficult to compare.

Correlation between six ESG ratings providers

	KL SA	KL MO	KL SP	KL RE	KL MS	SA MO	SA SP	SA RE	SA MS	MO SP	MO RE	MO MS	SP RE	SP MS	RE MS	Average
ESG	0.53	0.49	0.44	0.42	0.53	0.71	0.67	0.67	0.46	0.7	0.69	0.42	0.62	0.38	0.38	0.54
E	0.59	0.55	0.54	0.54	0.37	0.68	0.66	0.64	0.37	0.73	0.66	0.35	0.7	0.29	0.23	0.53
S	0.31	0.33	0.21	0.22	0.41	0.58	0.55	0.55	0.27	0.68	0.66	0.28	0.65	0.26	0.27	0.42
G	0.02	0.01	-0.01	-0.05	0.16	0.54	0.51	0.49	0.16	0.76	0.76	0.14	0.79	0.11	0.07	0.30

SA = Sustainalytics
SP = S&P Global
MO = Moody's ESG
RE = Refinitiv
KL = KLD
MS = MSCI

Source: https://www.plansponsor.com/thought-leadership/goes-esg-rating-deciphering-differences-third-party-esg-ratings/

Correlation between ESG rating agencies vs. credit rating agencies

0.61	**0.96**
Correlation among major **ESG** ratings agencies	Correlation among major **Fixed Income** credit ratings agencies

Source: https://www.plansponsor.com/thought-leadership/goes-esg-rating-deciphering-differences-third-party-esg-ratings/

To illustrate, let us take the controversial but high-profile example of Tesla. The S&P 500 ESG has dropped Tesla for high governance and social risk factors, highlighting Elon Musk's dominant role in the company and its potential impact on corporate governance. Another agency – MSCI ESG, the largest ESG ratings provider by market share – rates the company as A on average in 2022 (downgraded from AA), highlighting it as a "laggard" in its Product Safety & Quality category, but a "leader" in Corporate Behavior. As for Sustainalytics, another major provider, which focuses on unmanaged ESG risks, it ranks Tesla 42 out of 83 companies in its automobile industry category. It has assigned Tesla a risk rating of 28.5, which corresponds to the medium risk category, and deems its management of ESG material risk to be "Average".

This is just one example among many different ratings telling different stories about the same companies.

Practitioners argue that, on the one hand, ratings' "high correlations could lead to group think. Some say this was one of the problems with credit rating agencies' (highly correlated) assessment of mortgage-backed bonds in the financial crisis of 2008. Low correlation can be considered a healthy and useful outcome from ESG ratings providers given high discrepancy between ratings and raw data."[5]

On the other hand, investors are calling for standardisation and correlation among ESG ratings. They argue this could add credibility to the discipline and send out more consistent messages to companies.

Here, we look at different challenges that add to low correlation, as well as at industry developments and what we can do about it.

Challenge #1: What?

Definition of ESG is loose and data are opaque

One of the key challenges comes from the definition of ESG, or rather the lack thereof. As there is no single, established definition of what "ESG" means (though this has been improving in recent years), ESG ratings providers may not be measuring the same thing. For example, some focus on assessing ESG business practices and comparing peers in the same sectors to distinguish leaders and laggards. In this case, they might be comparing fossil fuel companies with high ESG ratings to poorly rated peers. Others may start with a greater focus on sustainability. In this example, fossil fuel companies will see their rating capped because of their intrinsically unsustainable business.

In contrast, with credit ratings, as mentioned above, the definition of what is measured is much clearer, which partially explains higher correlations. Typically, a credit rating assesses a company's probability of default on the basis of its ability and willingness to pay back its debt. The exercise is not straightforward, hence why the correlation, while high, is not perfect (some companies can still be rated "investment grade" by one rating agency and "high yield" by another), but at least all credit rating agencies aim to assess the same thing.

Another frequent challenge of ESG integration is data, which, again, is less of an issue for credit rating:

- ESG data is not consistently reported across companies, geographies, and sectors
- Most ESG data is not audited and not standardised internationally
- Some ESG data is not easily available in public databases and is costly and difficult to obtain

ESG data challenges for investors

Leading Challenges Investors Worldwide Face When Implementing ESG Data, June 2021

% of respondents

Challenge	%
Overcoming lack of consistency in ESG scores	53%
Overcoming the limitations caused by the ESG ratings that rely on company self-disclosure	50%
The need to interpret and analyze third-party ESG data	45%
Addressing the limitations of ratings that focus on outdated/historic data	36%
Reconciliation with my organization's definitions, standards, and principles	28%

Source: https://www.emarketer.com/chart/255697/leading-challenges-investors-worldwide-face-implementing-esg-data-june-2021-of-respondents

As many of the processes start with data gathering, use of differing raw datasets leads to a divergence in ESG ratings.

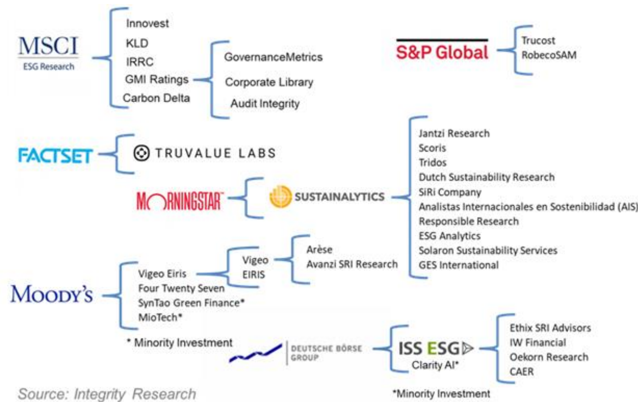
Challenge #2: Who?

Providers are heterogeneous

The ESG market continues to grow, with increasing numbers of providers and methodologies. There are more than 140 ESG data providers[6], differing in size, coverage, and geography. Many of them focus on broad ESG factors, although some, such as CDP (Carbon Disclosure Project), have a more specifically environmental focus. They include traditional ESG data and research providers stemming from the socially responsible investing industry and provide investors with sustainability data and ratings relating primarily to large, publicly traded companies. More recent consolidation activity has turned these providers into conglomerates with different offerings and research focuses[7].

More recently, non-traditional providers, such as credit-rating agencies (S&P and Moody's), entered the space, often through mergers and acquisitions. For example, S&P bought Trucost in 2016, and Moody's acquired Vigeo Eiris, a global leader in ESG research, in 2019.

Consolidation among ESG rating providers



Source: https://www.integrity-research.com/european-regulators-call-for-regulation-of-esg-data/

One of the latest trends is the use of artificial intelligence, or algorithm-driven ESG research. Data providers use new technologies to identify ESG risks and opportunities from web-based sources.

Differences in coverage mean users of ESG ratings need to work with several providers simultaneously. According to a recent statement from ESMA, "…their reasons for selecting several providers are to increase coverage, either by asset class or geographically, or to receive different natures of ESG assessments. The most common shortcomings identified by the users were a lack of coverage of a specific industry or a type of entity, insufficient granularity of data,

and a lack of transparency around methodologies used by ESG rating providers."[8]

Challenge #3: How?

Scope, measurement, weight

Methodologies used by providers differ considerably.

A 2022 paper by Florian Berg, Julian Kolbel and Roberto Rigobon of MIT and the University of Zurich explores what causes "aggregate confusion"[9] among ESG rating agencies and highlights three factors driving divergence:

- Measurement, accounting for 56% of the confusion. This is about which protocol, standard or scale providers use for their measurements.
- Scope, accounting for 38% of differences. This is about what providers measure (for example, one ESG rating agency might include lobbying activities, while others might not).
- Weight, accounting for the remaining 6% of divergence. This is about how important the ESG rating agency deems a given attribute.

market structure for ESG rating providers in the European Union. It said it is seeing "growing momentum" among regulatory bodies to address the issues of ESG rating providers after their shortcomings were again exposed in recent industry feedback.[10] In turn, the Financial Conduct Authority in the UK released a statement on 29 June saying it supported the government's plans to bring the oversight of ESG ratings under a regulatory umbrella.[11]

Alongside the definition of standards for ESG providers, another important development includes regulatory requirements for non-financial reporting by corporates, which are increasing internationally. For example, the EU is set to adopt the Corporate Sustainability Reporting Directive (CSRD), which will replace the Non-Financial Reporting Directive (NFRD) and considerably expand reporting requirements and the scope of application. The introduction of EU taxonomy aims to increase transparency and standardisation within financial products, which will help to compare datasets across companies and help investors make greener choices.

Comparison of major ESG ratings (indicative data)

	MSCI	SUSTAINALYTICS	Bloomberg	S&P Global	RepRisk
Coverage	13,500 companies	11,000+ companies	11,500+ companies	7,500+ companies	145,000+ companies
Sources	- Disclosure of companies - Databases (government, science, NGOs) - News and media	- Disclosure of companies - Media - NGOs	- Disclosure of companies - Multiple ESG third party providers	- Sector-specific questionnaire	- Media - Other public information - Exclusion from corporate reporting
Score Upper - Low	AAA-CCC	0-100, 5 Risk level	Off 100	0-100	0-100, AAA to D
Number of topics	37	40 (industry specific)	120	20-30 (branch-specific)	86
Participation	Companies are invited to verify data	Companies are invited to provide feedback and additional data	Companies can request updates at any time	Companies fill out questionnaire	No interaction

Source: on the basis of data from https://sustainserv.com/en/insights/esg-ratings-and-rankings-why-they-matter-and-how-to-get-started/, December 2020

Regulation

Regulators have been talking about the need for standardisation in the ESG industry and so ESG ratings are under renewed scrutiny.

Both European and UK securities market regulators have recently released statements on the need to introduce regulatory safeguards for ESG ratings. On 27 June ESMA published a letter to the European Commission providing its findings from a Call for Evidence to gather information on the

What can be done about it?

Even though ESG ratings remain divergent and complex, it should not be seen as an obstacle, but rather an additional source of information, which can be used to generate alpha. This is where we as a bank can bring added value to clients by providing the capability of internal analysis and collaboration with external rating providers, as well as by helping to navigate the changing regulatory environment.

Different investors have different purposes when using ESG ratings as a broader instrument, and the discussion on this can help to meet clients' needs better. While some investors

use ESG as a tool for risk management, others use it to improve their position on sustainable finance in order to align with societal and impact issues.

Taking into account the following factors could help investors to use ESG ratings effectively.

The first is ***transparency***. It is paramount for investors to understand what is being measured and why. According to Verena Ross, chair of ESMA, "different ESG ratings can have different measurement objectives, and these can be helpful in view of the various purposes and needs users may have. What is important is that whatever the objective, this is clear to the user, and the methodology followed is transparent."[12]

The second factor is ***comparability.*** Methodologies can diverge, but what matters is that they can be compared. Federica Casarsa, policy officer at Eurosif in Brussels, says that "…information should help investors better navigate the differences between methodologies rather than minimising those differences."[13] One of the initiatives taken to address this was the creation of the European Financial Reporting Advisory Group (EFRAG) and, more recently, the International Sustainability Standards Board (ISSB), a new standard-setting board. Its goal is to deliver a global baseline of sustainability-related disclosure standards in order to achieve comparable ESG reporting.

Finally, ***materiality assessment*** is key, both for investors and for companies. As there are many approaches in terms of what is measured and how, investors should identify what factors matter to them most and focus on providers that best fit their needs or, if possible, use different providers to conduct better-informed analyses. In turn, companies need to run materiality assessments to identify factors fundamental to their long-term success and make sure they do not end up being rated on issues that are not material to them.

The ESG rating market is developing rapidly and adapting to these needs. According to Eurosif's feedback to the European Commission, there could be a split in the market in the future, whereby among those asset managers with more sophisticated investment strategies, the demand for raw ESG data and derived products will grow more significantly than the demand for ESG ratings, while ESG ratings might continue to play a prominent role in some investment strategies such as passive index-based strategies.[14]

The conclusion is that, "…ESG rating divergence does not imply that measuring ESG performance is a futile exercise. It highlights that measuring ESG performance is challenging, that attention to the underlying data is essential, and that the use of ESG ratings and metrics must be carefully considered for each application."[15] It also highlights the added value that a bank can provide to its clients through the capacity of internal analysis, access to industry players and resources to explain regulation and the changing landscape.

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